

Journal of South Asian and Middle Eastern Studies

Vol. XXVI, No. 4

SUMMER 2003

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Contributions

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Articles appearing in this Journal are abstracted and indexed in HISTORICAL ABSTRACTS and AMERICA: HISTORY AND LIFE.

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ISSN: 0149-1784

Produced by Villanova University Graphic Services

Problems in Using International Trade to Counter Terrorism: The Case of Pakistan

Robert Looney*

Even before the smoke had settled from the September 11 attacks in New York and Washington, United States Trade Representative Robert Zoellick launched a series of speeches arguing that global trade liberalization was a central plank of the counter-offensive against terrorism. In a thoughtful essay, "Countering Terror With Trade" Zoellick's main premise was that:¹

America's trade leadership can build a coalition of countries... Open markets are vital for developing nations, many of them fragile democracies that rely on the international economy to overcome poverty and create opportunity; we need answers for those who ask for economic hope to counter internal threats to our common values. To address the relationship between trade agreements and other international objectives the President has proposed that we build on openness and growth in developing countries with a tool box of cooperative policies.

As Tonelson notes, "trade policy as anti-terror weapon is an understandably appealing idea. It doesn't put American soldiers in harm's way. It is nonviolent, market-friendly and holds the promise of 'draining the swamp' where terrorists are assumed to thrive. And it doesn't require a line in the federal budget."²

*Robert E. Looney is a professor of economics, and Associate Chairman of the National Security Affairs department at the Naval Postgraduate School, Monterey, CA. He has written twenty books on various aspects of development together with articles appearing in a number of scholarly journals. ¹Zoellick, Robert B, "Countering Terror With Trade" *The Washington Post*, September 20, 2001, A35.

²Tonelson, Alan, "There's Only So Much That Foreign Trade Can Do" *Washington Post*, June 2, 2002, B1.

United States Trade Responses to 9/11

Early on after 9/11 it looked as if the Bush Administration would add trade policy to its anti-terrorism arsenal. In fact, two weeks after 9/11 the Senate passed a bill approving a free trade agreement with Jordan, the first of its kind with an Arab nation.

"Some experts see in these events two possible futures for the Islamic world, and a role for the West in determining which one is realized. That role is to help Islamic countries create material hope for their people."³

In another major post 9/11 trade initiative, President Bush set out last fall to assist the Pakistani economy as part of an effort to reward the country for joining the US campaign against Osama bin Laden and the Taliban regime in neighboring Afghanistan. The idea was simple: Support Pakistan's economy by easing the tariffs and quotas on imports of Pakistan-made textiles and apparel. The more Pakistanis who have decent jobs, the fewer potential recruits for Islamic extremists trying to destabilize the pro-American government of President Pervez Musharraf. Optimistic Pakistanis saw this as a potential grand gesture toward their country, similar to the 50 percent increase in textile quotas that the first Bush Administration granted to Turkey as a reward for its help in the 1991 Persian Gulf War.

Rational of U.S. Trade Policy towards Pakistan

The economic rational behind increasing quotas and reducing tariffs is quite logical and compelling. The starting point is what is often called the neoclassical theory of comparative advantage. Basically this theory states that countries have a comparative advantage in exporting those products that use relatively large amounts of their most abundant resources (land, labor capital, technology etc.). In Pakistan's case the relatively large amounts of semi skilled workers should guarantee relatively low wages (and hence low costs) in those processes using this type of factor. The result would be an increase in the country's ability to offer these products at low prices in international markets. Under these conditions, increased US trade with Pakistan would increase employment in the country's large strategically important textile sector.

³Khan, Joseph "A Business Plan for Islam Inc." *The New York Times* December 30, 2001 <http://www.cid.harvard.edu/cidinthenews/articles/nyt-123001.html>

The advantage of this approach also stems from the fact that that many workers in Pakistan feel that they get no benefit from the aid or debt relief the US provides the Pakistani government. The most direct link from the US to the Pakistani population is often perceived by the population at large as that through direct employment in sectors such as textiles.

The Pakistani textile industry which took off in the 1980s employs 3.5 million, about 60 percent of the industrial workforce. These figures understate the sector's importance because textiles create linkages for income generation all through the economy. Much of the cotton used in making Pakistani garments is grown here. The Faisalabad market is one of the largest yard markets in Asia. If there is a shortfall anywhere in the chain it affects everyone's income.

President Bush's trade initiatives to assist the Pakistani Textile sector were made even more imperative by events immediately following 9/11: insurance companies began charging exorbitant premiums for shipments out of Pakistan; American textile buyers refused to venture into a potential war zone and cold-footed manufacturers reduced their orders. As a result, textile exports to the United States – about 80 percent of Pakistan's total U.S. exports – dropped by 40 percent. By December an estimated 48,000 workers had lost their textile jobs. As one observer noted "that's 48,000 more Pakistanis with nothing to do but take to the streets, cheer on Osama bin Laden and burn the American flag", or as the former manager of a closed textile plant grimly noted "An empty belly is a breeding ground for all sorts of bad ideas."⁴

Congressional Impediments

But in an example of how the tempestuous politics of trade on Capitol Hill can upset U.S. foreign policy aims, the plan to help Pakistani exporters ran aground, victim of a lobbying campaign by the USA's own battered textile industry.⁵ While President Bush has obtained authorization from Congress to negotiate new trade deals, Congress is sharply divided over trade politics. While there are notable exceptions,

⁴Quoted in Paul Wiseman and James Cox "Competing Interests Tangle Textile Policy" *USA Today* April 1, 2002

<http://www.usatoday.com/money/covers/2002-04-02-pakistani-textile.htm>

⁵Brainard, Lael, "Textiles and Terrorism" *New York Times* December 27, 2001 A19.

Republicans tend to support more open markets, while many Democrats try to protect such industries as steel and textiles from being overwhelmed by cheap imports. Many Democrats support the use of trade sanctions to enforce social goals such as higher labor and environmental standards abroad, while most Republicans reject these sanctions as protectionism.

Over the last 40 years or so the United States trade policy has sought to limit imports of textiles from countries with cheap labor. Since 1996 the WTO has heard three textile cases against the U.S. policy. In 1996, the WTO ruled against US quotas limiting imports of Costa Rican underwear; the next year, the trade body ruled against U.S. quotas on wool shirts from India. Ironically in early 2001 the U.S. lost its third big textiles trade case as a World Trade Organization panel ruled that a U.S. quota on Pakistani cloth violates global trade rules.

To make their case for special treatment in the U.S. market Pakistani manufacturers formed a lobbying group and hired US lawyers and public relations consultants. They hoped for trade concessions worth perhaps \$400 million a year. They argued that reducing trade barriers wouldn't threaten jobs in the American South, the heart of the U.S. textile and apparel industry. They said they compete not against U.S. firms but against mills in countries such as South Africa, Jordan and Kenya, which enjoy easier access to the U.S. market. Pakistan ranked 21st last year in U.S. apparel imports with less than 2% of the market.

But the U.S. textile and apparel makers and their powerful patrons in Congress weren't to budge. They pointed out that Pakistan's own tariffs on textile and apparel imports are so high that, in some cases, they violate international trade rules. And Pakistani cotton subsidies were so lavish that American cotton was priced out of Caribbean garment factories.

Failed Outcome

In the end the U.S. textile lobby and its congressional supporters were a formidable adversary and won the day. During Musharraf's mid-February visit to Washington, President Bush announced that in addition to offering \$1 billion in debt relief to Pakistan, the United States would increase its quotas in specific import categories in a package worth \$142 million, in 2002, \$158 million in 2003 and \$178 million in 2004. That is around a third of what Pakistan wanted.

Pakistani mill owners complained that the as part of the agreement U.S. tended to raise their quotas in categories they didn't much need. In the most eye-catching example, the U.S. raised Pakistan's quota for woven blouses for women and girls, a category in which Pakistan used only 18% of its 2001 quota.

The outcome also provided both countries with a hard lesson about the workings of present day globalization. The fact is that in an increasingly globalizing economy market forces are such that modern corporations show little loyalty to any particular country or workforce, but adapt quickly as they seek the most profitable and cost-effective locations from which to conduct business. This case shows how such moves can have geopolitical consequences: Even though no evidence suggests that U.S. companies were driven by an animus toward Pakistan, their actions galled many in that country because they came at a time when Islamabad has provided vital backing to the U.S. led coalition against terrorism.

In addition there are several real ironies here. The U.S. textile industry spent millions of dollars lobbying to retain quotas even though they have to be phased out in 2005. More specifically, under World Trade Organization rules, the textile quotas of Pakistan and many other American trading partners, including India, were automatically raised by an additional 12 per cent at the start of this year, part of a process that is to lead to the global elimination of textile quotas by 2005.⁶

On the other side, Pakistan has fought hard to expand their quota in the US market even though it is not clear that after 2005 they will be competitive even in their own domestic market.

Policy Failure in Pakistan

There are several factors at work here. Poor policy making on both the part of the government and the companies has burdened the industry with high costs and a limited line of products. In addition the country's relatively slow pace of globalization, especially in the 1990s has resulted in little innovation and productive investment.

⁶Mujahid, Haroon, "Understanding WTO Framework" *Pakistan & Gulf Economist* July 23, 2001 <http://www.pakistaneconomist.com/issue2001/issue30/etc4.htm>

The prestigious Pakistan and Gulf Economist has noted that⁷ "(While) the textile sector contributes the highest percentage in total exports of the country, the main products are yarn, grey fabrics and low and medium quality goods. The average unit price realization is often below the world average. The Government of Pakistan (GOP) policies have always been, even today, influenced by certain pressure groups. The result is: glut of locally produced yarn, inadequate and inefficient weaving, processing and manufacturing facilities. The exponential expansion of spinning capacity has been done at the cost of other sub-sectors adding the highest value. For this dismal economic situation the economic managers are responsible ... our failure was due to inability to cater to the needs of the market."⁸ One result is that the country has tended to rely increasingly on a few products and on exports with stagnating unit values, in contrast to the most successful Asian countries.

Government Policies have also been misguided in other ways. Textile firms have been forced to rely on the medium staple cotton grown in Pakistan. While this takes advantage of Pakistan's static comparative advantage in production of cotton, it does little to enhance Pakistan's export growth prospects, or to reduce its dependence on a single commodity. The narrow product lines also made it more difficult for the U.S. to come up with a quota reduction plan that was acceptable to the domestic textile lobby.

Until recently the textile industry benefited from cheap cotton at the expense of cotton growers through the cotton export tax and export restrictions that were eventually relaxed during the 1990s. Perhaps more significantly, high import tariffs (25 percent to 35 percent) on imports of semi-manufactured textile inputs – particularly protection on polyester which remains at 25 percent – coupled with poorly functioning import duty and sales tax rebate schemes have been a major obstacle to improved export performance and diversification. They penalize the industry for any attempt to expand beyond the narrow and low quality range of yarn and cloth produced locally

In this light the phasing out of quotas in 2005 confronts the sector with both a risk and an opportunity. The risk is that Pakistan's main textile exporters will no doubt need to undertake considerable investment

improved production techniques and technology or find themselves highly vulnerable to low cost Chinese and other developing country imports.

Here there is room for concern. The investment climate in Pakistan has in the recent past been characterized by frequent unanticipated policy changes, exacerbated by domestic and regional political instability. Pakistani and foreign industrialists often cite this as an important contributing factor to the decline in domestic and foreign investment in the country. Policy uncertainty was in part a function of the mounting debt crisis of 1990s but it also stemmed from policy slippages and reversals by successive governments throughout the decade. While the current government is trying to provide more stability, domestic terrorist threats, potential conflict with India and uncertainty over the policies of the next (post October 2002) Administration have just about brought new capital formation to a halt. The outlook for a major influx of investment and technology transfer to the industry is extremely grim.

Finally with regard to globalization and the country's place in the world economy, impressive strides were made in the 1990s in creating a more open economy. The average import tariff declined to just over 20 percent in 2001-02, which is less than half its level in the mid-1990s. Other barriers to trade such as exchange market distortions and non-tariff barriers have also been reduced. However this action falls short of the reductions in protection made by the countries such as Indonesia, Mexico, and Philippines with which Pakistan competes in world markets for labor intensive products.

The result has been a long period of Pakistan losing ground to many of its current and likely future competitors. In terms of openness to trade and international market forces, a major determinant of international competitiveness, Pakistan despite the lowering of tariffs and trade restrictions noted above, has even experienced a relative decline (Chart 1) with regard to other countries since the late 1980s. At the same time other South Asian countries, India and Sri Lanka have shown a slight improvement. No doubt this pattern is reflective of many of the government's policies towards the textile industry noted above.

Similarly, the overall globalization of Pakistan and South Asian regions has also declined during this period with regard to both the advanced countries and those in East Asia (Chart 2). The implications for Pakistan are dire. At a time when Pakistan needs to increase its

⁷Kazmi, Shabbir H, "Textile Ministry Need of the Day" Pakistan & Gulf Economist January 15, 2001 <http://www.pakistaneconomist.com/database1/covers/c2001-2.htm>

⁸Ibid.

competitiveness it is coming off a long period of declining ability to compete in the new world of global markets free of quotas and subsidies.

Main Lessons for Countering Terror with Trade

While the Pakistan example illustrates some of the problems involved in countering terrorism through the use of international trade policies, it is only one example and no doubt unique in some respects. Nevertheless, it can serve as the basis for several tentative policy prescriptions:

1. Regardless of how well-intended, the President of the U.S. should not make broad economic promises that require Congressional approval, especially in cases where adversely effected domestic interests are well organized.

2. Do not try to speed up formal processes that are in place. WTO textile schedule for 2005 is a good example--this only alienates other countries.

3. Do not expect to quickly reverse or significantly modify long standing adverse trends in the world economy or globalization. In Pakistan's case rapidly moving to freer trade may create more instability than stability.

4. While standard economic theory provides guidance as to comparative advantage and thus efficient trading patterns, government policy distortions can neutralize or negate this advantage.

5. Do not look to simple solutions to complex problems – Pakistan's textile problems probably can not be resolved with increased quotas. The solution is investment in new growing areas, not trying to hang on to capacity that is unlikely to be competitive without continued subsidies and/or protectionism.

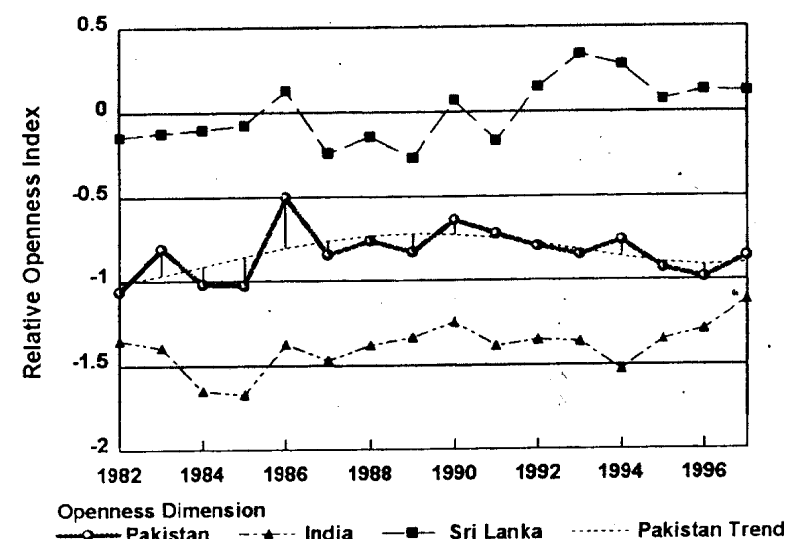
6. Do look to innovative approaches. Here for example, the U.S interests would probably be better served through the provision of some sort of political risk insurance/investment guarantees to US/Pakistani firms in the textile sector.

7. No doubt much of the aid and debt relief sent to Pakistan should have been used to directly support the textile sector, especially in the interval of falling orders right after 9/11.

If Pakistan had been a country with years of good governance, experiencing strong, stable investment patterns, while undergoing increased

openness and globalization and possessing a highly literate workforce, standard economic theory would have been relevant. The environment would have been much more conducive to the effective use of trade policies to fight terrorism. In short, the Congressional watering down of the President's tariff/quota initiative toward that country might not have been the disaster it first appeared to be.

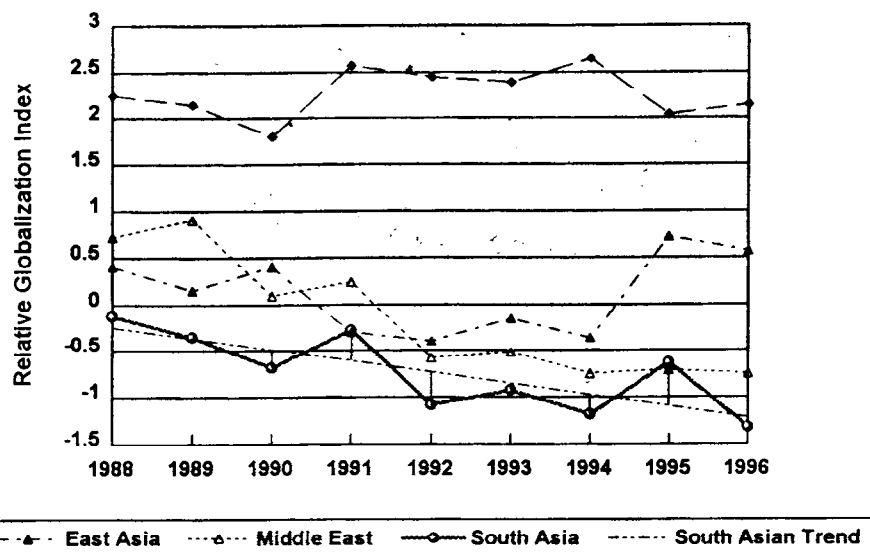
Chart 1 Relative Openness to International Trade; South Asia



Notes: Factor analysis was used to define globalization and its main dimension, openness are given in Looney (2002); Output = trend in Pakistani openness.⁹ Vertical scale is for a sample of 60 countries. It has a mean of zero; hence countries with negative scores score relatively low in their attainment of world economic integration.

⁹Looney, Robert "Oil Price Movements and Globalization: Is There a Connection" *OPEC Review* September 2002, pp. 246-252.

Chart 2 Relative Globalization - South Asia Relative to other Regions



Notes: See Chart 1 for the derivation of the globalization index. Vertical scale is for a sample of 60 countries. It has a mean of zero; hence countries with negative scores score relatively low in their attainment of world economic integration.